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USDOC FOR ITA DAS KASOFF, MELCHER, MAC/OCEA
NSC FOR LOI, SHRIER
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
STATE PASS CFTC FOR OIA/GORLICK

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TAGS: CH ECON EFIN EINV ETRD PGOV
SUBJECT: (SBU) EAST CHINA SEES CORPORATE BOND MARKET OPENING SLOWLY

¶1. (SBU) Summary. Foreign-invested banks in Shanghai generally agree that they will take only gradual steps into local corporate bonds traded on the interbank market. Several banks are still studying the market conditions, although one disappointment already is that foreign-invested banks most likely will not initially be able to underwrite new corporate bonds. Our contacts said that their caution regarding entering the Chinese bond market extends from several problems with China's bond market, including an inadequate credit rating system, high cost of hedging, low trading volume, lack of a yield reference curve, lack of a bond default process, and inability to perform interest rate swaps. End summary.

¶2. (SBU) Background: During the fifth Strategic Economic Dialogue, the United States and China agreed that "China will allow foreign incorporated banks in China to trade bonds in the inter-bank market, both for their customers or their own accounts, on the same basis as Chinese-invested banks," according to the joint U.S.-China fact sheet, released on December 5, 2008. Chinese regulators subsequently announced that foreign-invested banks would also be able to trade and underwrite bond issues on the inter-bank market, expanding on the original language. Foreign banks are still unable to trade or underwrite bonds on the bond exchange for listed companies regulated by the China Securities Regulatory Commission (CSRC). End background.

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Foreign Banks Considering Small Steps Into Bond Market
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¶3. (SBU) Our contacts among foreign-invested banks in Shanghai in a series of meetings in recent weeks have generally agreed that they will take only gradual steps into the local corporate bond market. Although the China Banking Regulatory Commission (CBRC) issued a notification in mid January potentially opening the door for foreign-invested banks to buy, trade, and underwrite corporate bonds, the first step for most banks will be simply to buy and hold.

¶4. (SBU) Several banks are still studying the market conditions, say our interlocutors. A Hang Seng Bank representative took one of the most conservative positions among our interlocutors, saying that he is pessimistic about the market conditions and that the bank's internal risk controls will not allow a quick move into corporate bond plays. Others are more optimistic, including Citi-- especially interested in trading short- and medium-term notes, which have tenors of one to five years--HSBC, and Deutsche Bank. (Note: So far, only one bank has purchased a non-financial corporate bond. Standard Chartered Bank on April 6 announced that it bought commercial paper, according to several local media reports. End note.)

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However, Underwriting Will Not Be Possible For Now . . .
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¶5. (SBU) Foreign-invested banks will not be able to underwrite new bond issues by corporations in the near-term, agreed our contacts. This excludes them from the area of the bond market where foreign risk assessment tools would be most useful, and potentially the fees and profits the greatest. Even should underwriting eventually be permitted, several contacts believe that foreign-invested banks will be required to be a part of an underwriting group, and not the lead underwriter.

¶6. (SBU) The distinction between buying and trading, on the one hand, and underwriting on the other is that the former do not require any additional licensing from the CBRC, say our interlocutors. A Citi representative said that he anticipates that the CBRC Shanghai Office may ask some questions of banks

interested in buying and trading corporate bonds, questions which he implied could be quickly answered satisfactorily.

¶7. (SBU) At the same time, other interlocutors saw potential hang-ups from other regulators before foreign-invested banks can buy and trade corporate bonds. An HSBC representative said that, just as with domestic banks, the People's Bank of China (PBOC) will require that foreign-invested banks acquire PBOC approval before buying and trading short- and medium-term notes on the inter-bank market. To do the same on behalf of clients, HSBC said, PBOC will require a statement of PBOC approval and a custodial license. For the latter, there are significant staffing and training requirements, said HSBC, and in addition, the PBOC appears to be seeking to limit the expansion of custodial licenses. Currently, 30-40 banks nationwide have custodial licenses, but the PBOC has put licenses on hold while it develops new application standards.

¶8. (SBU) A more significant problem in getting approval for underwriting is probable foot dragging by the National Association of Financial Market Institutional Investors (NAFMII). The association is composed of the chief executive officers or chief financial officers of China's major domestic banks, said several of our interlocutors, and not only controls bond issuance schedules, but also regulates which banks are permitted to be bond underwriters. As a Deutsche Bank representative described it, through this regulatory body, Chinese domestic banks control access to the corporate bond market. HSBC's representative said that NAFMII promised HSBC to issue guidelines for applying to be a bond underwriter early this year, but implied that it would not approve this for foreign-invested banks for the near future. In addition, underwriting also requires CBRC approval, which will also require negotiations, said HSBC.

¶9. (SBU) As a result, our interlocutors said that the process of getting approval for underwriting would likely take several months. Standard Chartered's representative, for instance, said the bank would trade bonds for several months while hoping for approval to underwrite bond issues by September. NAFMII is justifying its slowness on these approvals by arguing that foreign banks will not be willing to underwrite bonds anyway,

because they are too risky in China, and that no foreign bank has an adequate platform to support underwriting bonds, according to HSBC's representative.

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. . . And Flaws in the Bond Market Are Discouraging
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¶10. (SBU) Our interlocutors admitted that foreign-invested banks will be reluctant to jump into China's corporate bond markets as a result of several concerns. These include:
- Inadequacy of the corporate credit rating system: JPMorgan's representative said that it is difficult to compare risk-return ratios across different companies, or even to evaluate a single company. Our Hang Seng contact simply said that Chinese companies are not rated because they have such poor credit.
- Hedging is expensive: JPMorgan's representative mentioned a second problem related to the first. The cost of purchasing credit debt swaps to offset some of the risk in Chinese corporate bonds is so high that it wipes out the spread in yields over Chinese government treasuries, making it more remunerative to simply invest in treasuries.
- Low liquidity: Only 2 percent of Chinese bonds are "real" corporate bonds, said a representative of joint-venture securities firm HSBC JinTrust. Most are issued by the government or financial institutions and are held by insurance companies to maturity, leaving few to be traded in the market, he noted.
- No bond yield reference curves: Hang Seng's representative

said that bond coupons are not market driven--China does not even have a market-driven government bond yield curve for a full range of maturities. The contact described the interbank bond market as segmented. On the one hand, bonds of maturity from one to three months are set by market forces, in part due to an active repo business. On the other, bonds of maturity from four months to one year are also traded through one-off agreements between banks--a system that has been approved by the CBRC and PBOC--and these less-liquid markets lead to much higher interest rates. As a result, the three-month interbank rate is 1 percent, but the one year rate is 4.5-5 percent.
- The Chinese Government discourages corporate bond defaults. Our interlocutors all shared the observation that very few, if any, corporate debt defaults had recently occurred in China. In fact, regulators require that underwriters guarantee their bonds, so that investors have recourse in case the business runs into financial difficulty.
- Most foreign-invested banks are not permitted to carry out interest rate swaps: Only JPMorgan is a corporate bond market maker among the foreign-invested banks, which at first was a position of high responsibility but little gain, said Standard Chartered's representative. However, the CBRC in 2008 year tied this status to approval for interest rate swap products. Standard Chartered has since applied--and been rejected--three times. Citi's representative agreed that corporate bond market maker status would be useful, since with it comes access to PBOC meetings.

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Bonds Will Compete With Bank Loans
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¶11. (SBU) Banks want to deal in bonds because development of this market in China is inevitable, foreign banks are highly restricted from underwriting and trading equities, and interest rate controls limit the ability of foreign banks to compete with Chinese banks on corporate loans. Our interlocutors pointed out that bank lending and bonds are substitutes, to some extent. For instance, the volume of bond issuance increased in the past two years under credit quotas, but since the beginning of 2009 bond demand has fallen as lending surged, said a representative of China Merchants Bank.

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Comment

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¶12. (SBU) Bond market development remains an important priority for Chinese regulators, as a means to provide more market oriented financing and improve the efficiency of financial intermediation. In particular, Chinese officials hope to emulate the experience of the U.S. and other countries by allowing large companies to access more financing in the bond market, thus freeing up more bank lending for small and medium-sized enterprises. Foreign-invested banks in East China welcome any signs of progress in financial innovation and opening to non-domestic players, given the difficulties and discrimination they experienced this past fall during the height of the global financial crisis. However, our contacts among foreign-invested banks are suspicious that their domestic competition continues to manipulate regulatory bodies to exclude them from potentially high-fee bond underwriting business. In particular, CITIC and China International Capital Corporation (CICC) appear intent on maintain their large market share for bond underwriting. With the experience foreign-invested banks earned pricing risk and marketing bonds in developed economies--despite doubts raised by problems with developed-country financial markets as a result of the ongoing crisis--bond underwriting is an area where foreign-invested banks could potentially bring the greatest value-added.
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